SMES, DIRECTORS & SHAREHOLDERS

Directors' duties and responsibilities

What constitutes misconduct: Part 1. General guidance

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INTRODUCTION

This is part 1 of a series of 5 booklets considering the general question of directors' conduct and what can ultimately constitute a finding of "unfitness" and possible disqualification as acting as a director.

Unfitness is governed by section 6 of the Company Director Disqualification act 1986 ("CDDA 1986").

This series of booklets is intended to guide you through the general standard of behaviour expected by the courts on either: (i) an objective basis – i.e. the standard expected of directors generally; and (ii) a subjective basis – i.e. the higher standard expected of directors having regard to their qualifications, skills and experience.

Although cases are always judged on their own individual facts, certain common threads can be determined from the various decisions made by the courts when determining unfitness pursuant to Section 6 of the CDDA 1986.

1 Disqualification for incompetence

A director can be disqualified for incompetence.

When judging "competence," a court will look at a wide variety of factors when determining unfitness. These include:-

1. **The type of business concerned;**
2. **The size of the business;**
3. **The experience or skills that the director holds himself/herself out to have;**
4. **The actual experience and skills s/he has; and**
5. **The allocated management responsibilities of that individual.**

The courts will always expect a director, regardless of his/her background, to meet a certain standard regardless of the industry s/he works within. If a director has the appropriate experience or other qualifications which demonstrate that expectations should be even higher than this minimum standard, then the court will apply such expectations when determining whether their actions constituted unfitness.

A director has duties both to those who have direct interests in the company – shareholders, other directors, employees and creditors, and those who have indirect interests – government via policy concerns, potential customers in respect of advertising etc. and the public generally in terms of who the goods and services are marketed.

A breach of any of these duties can lead to a finding of unfitness in disqualification proceedings.

2 Disqualification for inactivity or failure to act

If a director has remained completely inactive or has failed to act, this can in itself, constitute a finding of incompetence and lead to disqualification.

SPOUSES

This category is often applicable to spouses of directors who are themselves appointed directors and then take no involvement whatsoever in the running of the business. If that company then later goes into liquidation, the likelihood is that the failure alone by the spouse to take any involvement and/or interest in the running of the company will be sufficient for a finding of unfitness.

The fact that someone agrees to be a director of the company and may even be a signatory to a bank account, is in itself a breach of their duties as they are acting as a conduit for misbehaviour to occur without insisting on having any supervisory or other control over the company's affairs.

Such inactivity is no defence to a disqualification claim.

NEWLY OR RAPIDLY APPOINTED EMPLOYEES

Another danger is in circumstances where the director controlling the business promotes an employee to the position of director. This can often occur with relatively new, sometime graduate, recruits who may be ambitious and eager to obtain an early promotion. Often that person can be in "awe" of the main controller of the business or "dazzled" by a strong personality and take little if any part in the management of the company, or alternatively they could be overconfident about their own abilities without truly understanding the nature of the responsibilities they are taking on.

LATERAL HIRES WHEN TRADING GETS TOUGH

It is not uncommon for an experienced individual, when times are getting tougher, to recruit in an individual and quickly promote them to director, whilst at the same time resigning their own position and allowing this new individual to be seen to be controlling the company (and being disqualified as a director and potentially being subject to litigation proceedings when things go wrong). There is no such thing as a "free lunch".

Once you are a director you take up the entire responsibility for the company's corporate governance, its duties to all creditors (including Her Majesty's Revenue & Customs) and the approach to marketing and sales taken by the company and its employees.

3 The concept of individual and collective responsibility

The management of a company is vested in its directors. The running of the company can only be conducted through its directors.

Directors have (both collectively and individually), a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them to properly discharge their duties as directors.

In larger companies this requires detailed reporting structures and management processes to ensure that at every level there is accountability which goes up through the chain of command.

In assessing the question of unfit conduct, when faced with a disqualification claim, the court will look at the size and type of the business and the experience of the person, his/her role in the business and duties and responsibilities assigned to that person. Therefore, whilst the role of director is universal, the court will consider the actual roles and responsibilities of each individual director as well as their overall corporate governance responsibilities.

4 The duty on a director to keep informed and to supervise

There is a duty on a director to inform himself/herself of the affairs of a company and engage with co-directors in supervising and adhering to those duties.

If a director fails to monitor, supervise or keep himself/herself informed about the company, then this lack of knowledge can be no excuse in disqualification proceedings and any finding of unfitness (see our comments above).

A lack of control can be evidenced by a number of things such as:-

1. **Failing to hold board meetings;**
2. **Not issuing appropriate instructions to employees;**
3. **Not implementing appropriate reporting mechanisms where direct supervision is not possible;**
4. **Leaving important corporate matters to external bodies – for example expecting accountants to deal with all tax matters and accounts without any degree of involvement or review by directors (which is a direct contravention of Section 173 of the Companies Act 2006);**
5. **Not making adequate enquiries as to the company's financial position by reviewing management information or checking ledgers;**
6. **Not regularly monitoring adherence to statutory duties, including the requirement to deal with all PAYE/VAT and corporation tax returns, filing accounts and other returns to Companies House, adherence to anti-money laundering regulations, professional regulatory requirements and any fraudulent matters; and**
7. **Not ensuring that a company's creditors are treated in an identical fashion.**

It is vital that all directors take an active part in a company's management and in the interests of all parties and ensure that all parts of the company are operating in a manner that complies with the legal framework.

Any failure to do this cannot be justified unless there are unusual circumstances, for example fraud by an employee, illness, fraud by an external party and reliance on wrong advice (although this presents a difficult bar to meet where no negligence proceedings have been brought).

The privilege of limited liability is bestowed to directors and their shareholders, via the company, on the basis of the responsibilities that directors bear to ensure that they act in accordance with their duties. A breach of such duties can lead to disqualification proceedings (which would lead to their inability to act for a company in the future) and personal liability for the losses incurred (despite the assumed "limited" liability of the company).

5 Delegation of responsibilities to others

We are often asked what happens when a director delegates responsibilities to others in the company of a similar standing or level. Does this absolve the director if things later go wrong due to mistakes made by the other person to whom the task was delegated?

As an act, delegation is permitted and indeed necessary in the smooth running of larger organisations. A person cannot be expected to do everything in a medium to large sized company.

The courts are however clear on this point. Whilst directors can delegate functions to other people in the management chain, such delegation does not absolve a person from a duty to supervise the discharge of the delegated function. Indeed, the responsibility, should things go wrong, rests not just with the director who delegated the task. It rests with the entire board of directors if there is one.

When delegating a function, role or task, a director should:-

1. **Consider whether the person to whom the task or function is delegated has the appropriate skills and experience to carry out this task;**
2. **Ensure that the correct systems, individuals (e.g. mid-management) and structure is in place to ensure that adequate supervision of this individual is performed;**
3. **If necessary, depending on the seriousness and financial risk to the company, obtain the board's approval of the tasks being delegated and who to; and**
4. **Ensure that there is a concise record of who is doing what and the reporting procedures. Quite commonly, this type of record is a combination of the employment contract, staff manual and regular appraisals.**

However, it is important to realise that at all times the directors do have to have some trust in the employees of the company, as any failures by them are ultimately the directors' responsibilities.

6 Can a director be disqualified for matters which preceded his/her appointment?

Ordinarily a director cannot be disqualified for failing to remedy previous inadequacies in the company before s/he became a director.

However, quite often it is the case that a director comes in to "see out" the company, cover up for previous directors or extract what value is left in a company and all of these approaches are indeed worthy of criticism.

Additionally, a director's conduct will be assessed where s/he is appointed and does little or nothing to protect creditors from a deteriorating situation which preceded his/her appointment or where s/he could have done something to prevent a pre-existing situation from getting worse. An example of this could be where there are outstanding tax returns from previous periods and a director does not bring them up to date or act to deal with this liability.

7 Does it matter if the director hasn't drawn any remuneration from the company?

The answer is no.

A director can't avoid his responsibilities on the basis that s/he didn't earn anything from the business. However the converse is true. The higher the level of remuneration by a director, the more the court will expect that person to have been involved in running of the business – quite often we see the main interest represented by a shareholder who distances himself from any interest in a company but is paid the most.

8 Can I be disqualified for my role as a shareholder or a non-executive director?

The disqualification regime applies to all directors.

A director is not precisely defined in legislation but refers to all individuals who hold the position of director by whatever name called (Section 250 Companies Act 2006). This includes:

1. **De Facto directors – directors who are held out as directors or perform functions which could only be carried out by a director, but who are not formally recorded as director in the company's statutory records and at Companies House;**
2. **Shadow directors – those individuals who whilst not openly acting as a director may instruct the company's directors in the performance of their duties and the direction of the company. This is defined by Section 251 Companies Act 2006;**
3. **Corporate directors – i.e. companies who sit on the board of directors and are appointed as such;**
4. **Directors of corporate directors; and**
5. **Non-executive directors – whose responsibilities in respect of the management and direction of the company, including its financial affairs, are no different to that of appointed De Jure directors.**

If shareholders act in any of the above ways it will be extremely difficult to distance themselves from any allegations of unfitness as a director in director disqualification proceedings. As such, all individuals involved in the management of a company must be aware of what their role is and whether it is conduct that could only be performed by a director.

The general rule is that non-executive directors who fail to take part in the management of the affairs of the company can also be disqualified for unfitness. A non-executive director, as any other conventional director (see our comments above), can be disqualified for incompetence or any other finding of unfitness.

As a rule of thumb, non-executive directors in larger organisations are likely to be at less risk than those attached to smaller organisations. In larger organisations, non-executive directors are invited to attend board meetings and receive regular (and often better prepared) management information.

However, there is still a duty on the non-executive director to ensure that the information before him at a board meeting is accurate and that directors act properly in determining how to deal with any issues which may give cause for concern.

9 What can a director do if unable to remedy improper or inappropriate running of a company?

If a director discovers something "untoward" going in the company but cannot compel his co-directors to fix it, what should that person do?

Conventionally a director should raise these issues at a board meeting and ensure there is a minute of this meeting to record his concerns and suggestions to remedy the situation (it may also be advisable to keep a personal record of the minute).

If a majority of directors are unwilling to follow such suggestions or do not propose similar remedial action, or if the remaining directors refuse to attend the meeting, then there are very few alternatives available.

If the director is also a shareholder s/he may be able to take derivative action against the fellow directors or force the company to take the necessary steps proposed. However, if this is not possible, then the only alternative is for that director to resign.

Equally, simply resigning may not be enough to avoid criticism as that director is effectively leaving the company vulnerable to the will of the previous directors and therefore a decision has to be made as to whether there is a need to convene a shareholders meeting (if that director is a shareholder), report such concerns to government or regulatory authorities or to otherwise consider whistleblowing.

However, the answer when faced with the above situation is to try and remedy things and if this is not possible, to resign. To simply state "I did what I could" is no defence to a claim of unfitness.

10 Disqualification: "phoenix" Companies and reusing a company's name

The Insolvency Act 1986 set about adopting a procedure to prevent individuals as directors from repeatedly allowing companies to fail and immediately recommencing trading in the same name. These were and often continue to be referred to as phoenix companies.

A phoenix company may be used to prefer favoured creditors, mislead creditors and the public into believing the same business is continuing to trade (even though it has entered into liquidation) or enabling the continued provision of credit to pay for that director's lifestyle.

Under current legislation (section 216 of the Insolvency Act 1986) this is prohibited and is both a criminal offence (which a liquidator is legally required to report to governmental authorities and which can attach a director disqualification order) and a civil offence (where the director can be pursued for losses incurred by creditors of the phoenix company.

The breach of this legislation is quite commonly a basis for director disqualification proceedings and it is usually a difficult issue for an individual without legal knowledge to deal with. However there are statutory exceptions to the rule (which perhaps should be considered when it is intended to continue trading in the old company name) which can be relied on to rebut any allegations of unfitness.

11 Repeatedly failing companies

The courts do not treat all directors equally in circumstances where they have had a series of previous company failures. They make a distinction is often made between "honest" and "bad" phoenix companies.

An "honest" phoenix company is where a failure has happened through no fault of the management and the business had to be rescued by a successor company in the interests of the public and the creditors.

A "bad" phoenix company is characterised by intentionally dishonest behaviour and where the management are simply looking after their own interests through several continuously traded companies which repeatedly fail one after the other.

12 Continuation of a failed business model

A director can be disqualified if the successor company's business is simply a mere continuation of a failed business model with no real prospects of success.

In order to defend such an allegation, a director must show that the successor business had a different business model to the old company.

At FWJ, we successfully acted for an individual who established 3 successive bagel chain companies in 4 years, each of which failed owing over £1 million to HMRC. However, we successfully demonstrated that each company had a very different modus operandi with genuine prospects of success at the outset of each company. The Secretary of State later discontinued proceedings and paid our client's costs in full.

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